APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 06-1364

BAHIG F. BISHAY,
Plaintiff, Appellant,

v.

CITIZENS BANK OF MASSACHUSETTS,
Defendant, Appellee.

Entered: January 19, 2007

JUDGMENT

This cause came on to be submitted on the briefs and original record on appeal from the United States District Court for the District of Massachusetts.

Upon consideration whereof, it is now here ordered, adjudged and decreed as follows: The judgment of the district court is affirmed.

By the Court:

/s/ Richard Cushing Donovan
RICHARD CUSHING DONOVAN, Clerk

[cc: Mr. Bishay, Mr. Stroll, Mr. Ryan, & Ms. Busny.]

Not for Publication in West's Federal Reporter
Citation Limited Pursuant to 1st Cir. Loc. R. 32.1.0

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 06-1364

BAHIG F. BISHAY,
Plaintiff, Appellant,

v.

CITIZENS BANK OF MASSACHUSETTS,
Defendant, Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MASSACHUSETTS
[Hon. Richard G. Stearns, *U.S. District Judge*]

BEFORE

Boudin, *Chief Judge*,

Torruella and Howard, *Circuit Judges*.

Bahig F. Bishay on brief pro se.

Elise Busny, James W. Stoll and *Brown Rudnick Berlack Israels LLP* on brief for appellee.

January 19, 2007

Per Curiam. We affirm the judgment of dismissal substantially for the reasons recited in the district court's memorandum and order, *see* 2005 WL 2514929 (D. Mass. 2005), adding only the following comments.

To recover an unpaid loan, appellee Citizens Bank of Massachusetts ("Citizens") brought a state court action in 1995 against appellant Bishay and a company he owned (collectively "Bishay"). Bishay filed two counterclaims and later applied for bankruptcy protection. The ensuing reorganization plan contained a reservation clause, which permitted Bishay to pursue his counterclaims on condition that he procure a letter of credit ("LOC") to compensate Citizens for its expenses if it prevailed in state court. Bishay did so and then added four new counterclaims in an amended filing. At the summary judgment stage, the superior court concluded that the four new claims were not covered by the reservation clause and were subject to dismissal on preclusion grounds. The court rejected the original two claims on other grounds and later awarded attorney's fees to Citizens. When Bishay refused to make payment, Citizens collected its fees award in 1999 by drawing on the LOC. The state appeals court subsequently affirmed. *See* 56 Mass. App. Ct. 1104 (2002).

Bishay filed the instant action in 2005. In six counts, he charged that Citizens' draw on the LOC violated the reorganization plan and was actionable on various grounds including breach of contract. But his underlying allegations mirrored those he had earlier advanced in state court. For example, the LOC draw was supposedly unlawful (or at least premature) because the reservation clause had been misinterpreted and he had been wrongfully denied the opportunity to pursue his four new counterclaims. The district court deemed the complaint "an improper collateral attack" on the state court judgment and concluded that "Bishay's recasting of his dissatisfaction with the adverse rulings of [the state] courts into a breach of contract claim . . . does not alter the fact of preclusion." We agree.

The precise nature of Bishay's breach of contract claim—the only claim he has pursued on appeal—is unclear. At times, he appears to be raising a procedural objection: that

disposition of his counterclaims at the summary judgment stage was improper because the reservation clause entitled him to prosecute his claims through trial. At other times, he appears to be raising a more substantive objection: that the reservation clause barred Citizens from relying on a preclusion defense, regardless of the procedural mechanism chosen to do so. Yet this ambiguity need not be resolved, since both of these arguments involve the scope of the reservation clause. That issue has already been decided in state court, whose rulings are entitled to full faith and credit. Bishay cannot now relitigate the matter in federal court. *See generally McDonough* v. *City of Quincy*, 452 F.3d 8, 16 (1st Cir. 2006) (applying Massachusetts law of claim preclusion); *Johnson* v. *Mahoney*, 424 F.3d 83, 93 (1st Cir. 2005) (applying Massachusetts law of issue preclusion).

Bishay argues that his contract claim is not subject to preclusion because it did not exist in 1996 when he filed his amended counterclaims in state court. But his attempt to lump all such claims together for purposes of preclusion analysis is misplaced. The superior court found the counterclaims to be precluded by the bankruptcy court ruling. *See, e.g., In re Belmont Realty Corp.*, 11 F.3d 1092, 1095 (1st Cir. 1993) (noting that "normal rules of res judicata apply to decisions of bankruptcy courts"). By contrast, the district court found the contract claim to be precluded by the state court judgment. That the contract claim may not have existed in 1996 had no bearing on the district court's analysis.

Bishay also asserts that Citizens "opened the door" to his bringing the contract claim when it drew on the LOC in 1999. Yet his objections to the LOC draw, rather than advancing any new basis for relief, simply reproduce the arguments earlier resolved by the state court regarding the scope of the reservation clause. The district court properly rejected this attempt to get a second bite of the apple.

Affirmed.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

Civil Action No. 05-10451-RGS

BAHIG F. BISHAY,

v.

CITIZENS BANK OF MASSACHUSETTS.

October 11, 2005

MEMORANDUM AND ORDER ON
DEFENDANT'S MOTION TO DISMISS

STEARNS, *D.J.*

On March 10, 2005, Bahig Bishay brought this Complaint against Citizens Bank of Massachusetts (Citizens) alleging breach of the covenant of good faith and fair dealing, breach of contract, fraud, breach of fiduciary duty, unjust enrichment, and a violation of Chapter 93A (Counts I to VI, respectively). On April 7, 2005, Citizens moved to dismiss Bishay's lawsuit, arguing successively that the court lacks subject matter jurisdiction, that the Complaint is an improper collateral attack on a final judgment, that the Complaint is barred by the applicable statutes of limitations, and that it fails to state claims upon which relief can be granted.

This lawsuit is the latest chapter in a decade-old dispute. According to the Complaint, Bishay had been a long-time client of Neworld Bank and its predecessor Charlestown Savings Bank. In 1994, Citizens acquired Neworld and declared Bishay in default on an outstanding $2.5 million loan. Bishay paid the loan down to $1.5 million, but in June

of 1995 Citizens sued Bishay in Norfolk Superior Court for the unpaid balance. Bishay responded by bringing a counterclaim against Citizens alleging various types of lender misconduct.

On July 25, 1995, Bishay caused an entity he owned, 1095 Commonwealth Avenue Corporation, to file for Chapter 11 bankruptcy.[1] On April 23, 1996, the Bankruptcy Court confirmed a Plan of Reorganization (the Plan). The Plan subsumed Bishay's outstanding debt to Citizens, but by a reservation of rights permitted Bishay to pursue his lender liability claims in the state court on condition that he either post a $500,000 letter of credit (LOC) or grant Citizens a $500,000 lien on one of his properties.[2]

Bishay elected to post the LOC. Citizens then filed two consecutive motions for summary judgment, arguing that Bishay's counterclaim was either barred by res judicata or had been released under the terms of a 1994 Forbearance Agreement. In December of 1997, and in February of 1998, the Norfolk Superior Court ruled in Citizens' favor. Bishay then repaired to the Bankruptcy Court where he filed a "Motion to Clarify and Amend the Reservation Clause in the April 23, 1996 Confirmed Plan of Reorganization, Nunc Pro Tunc, and to Declare that the Alleged Claims of the Debtor are Non-Core." Bishay argued that intervention of the Bankruptcy Court was necessary to correct "the misunderstanding of the Norfolk Superior Court as to matters ex-

---

[1] Bishay filed a petition for personal bankruptcy in September of 1995, which was consolidated with the 1095 Commonwealth Avenue Corporation petition.

[2] The reservation clause stated in relevant part:

> [t]he debtors' estates may retain, and by its duly authorized agent representatives settle, release, or prosecute, their alleged claims against Citizens' arising from the transactions between the Debtor and Citizens and related matters . . . .

pressly reserved by the Bankruptcy Court for adjudication in the Norfolk Superior Court." The Bankruptcy Court rejected Bishay's plea and Bishay appealed to the Bankruptcy Appellate Panel (BAP). *See In re 1095 Commonwealth Avenue Corp.*, BAP No. MB 98-051 *1 (1st Cir. July 14, 1999). The BAP rejected Bishay's appeal holding that his motion for clarification was in reality an untimely motion to modify the confirmation of the Plan.

> In Bishay's case, the issues relating to plan interpretation of the scope of Bishay's reservation of claims and release could have been litigated in either the bankruptcy court or the state court. Bahig Bishay and 1095 Commonwealth Avenue Corp. took their chances with the state court and cannot now re-litigate the same issues here. The state court judgment entered against Bishay is entitled to full faith and credit.

Id. at *3.

In October of 1998, the Superior Court granted Citizens' third motion for summary judgment and dismissed Bishay's six-count counterclaim in its entirety. In addition to ruling in Citizens' favor on the merits, the Court awarded Citizens $360,000.00 in attorneys' fees. When Bishay failed to pay the fee award, Citizens reimbursed itself from the LOC. Bishay then appealed the summary judgment decisions to the Massachusetts Appeals Court. That Court affirmed the Superior Court rulings. *Citizens Bank of Massachusetts v. Bishay*, 56 Mass. App. Ct. 1104 (2002). Applications for further appellate review were denied by the Supreme Judicial Court and the United States Supreme Court.

Two years later, Bishay filed this Complaint *pro se* asserting, among other claims, a breach of contract. Bishay alleges that Citizens breached the April 23, 1996 Plan of Reorganization by drawing down on the LOC before his

counterclaim had been fully adjudicated on the merits.[3] Bishay contends that he was:

> entitled . . . to prosecute his Claims, so long as Bishay placed $500,000 in escrow. Citizens, on the other hand, and despite Bishay's compliance with his end of the bargain, deprived Bishay from the fruits of his bargain, as it led the state court to believe that Bishay's Claims were (a) extinguished in the Bankruptcy Court; (b) Bishay allegedly released said Claims in the Bankruptcy Court; and (c) Citizens was entitled to summary judgment, by disingenuously invoking the doctrine of res judicata, as if Bishay's Claims had already been tried and lost, which Citizens knew never happened.

Complaint, ¶ 15. At the crux of Bishay's contract claim is his belief that under the terms of the Plan he was entitled to a trial on the merits of his counterclaims, an entitlement that he lost when Citizens filed its underhanded and misleading summary judgment motions. Bishay maintains that under his "contract" with Citizens, he

> was entitled to freely prosecute his Claims after he placed $500,000 in escrow, and that if after he prosecuted the subject Claims he lost, Bishay was required to then reimburse Citizens for its out pocket costs in defending the subject Claims after the trial (an opportunity Bishay never had in any court, hence the "breach").

Complaint, ¶ 14.[4]

---

[3] The argument rests on the somewhat dubious proposition that the Plan of Reorganization was a contract to which Citizens was a party.

[4] Bishay contends that "the United States Bankruptcy Court indeed authorized Bishay to proceed with the prosecution of the subject claims. . . . It defies commonsense to now hear Citizens argue that it did not guarantee Bishay an opportunity to fully prosecute his claims. Bishay stated in his Verified Claim, Webster's New World Dictionary defines the meaning of the term

Citizens argues inter alia that Bishay's Complaint constitutes an improper collateral attack on a final judgment. Bishay maintains that his present claims are separate and distinct from his Superior Court counterclaims because they are based on Citizens' breach of the Plan and the reservation of rights clause and not on the substantive merits of the counterclaims themselves. Bishay's arguments are unpersuasive on a number grounds. First, even if the Plan could be considered a contract in some fashion binding Citizens, there was nothing in the reservation of rights that waived Citizens' right to mount a summary judgment defense and proceed instead to a trial on the merits. Citizens had the same right as Bishay to fully deploy its defenses including all proper procedural means permitted by statute and rule. A grant of summary judgment, contrary to Bishay's understanding, is a judgment on the merits. Nor did Citizens grant itself summary judgment or award itself attorney's fees. Those decisions were the office of the Superior Court. And as the Bankruptcy Court held, the Superior Court's rulings are entitled to full faith and credit.[5] *See Wright Machine Corp. v. Seaman-Andwall Corp.*, 364 Mass. 683, 688 (1974) (considerations of fairness and judicial economy dictate that there be an end to litigation and that those who have contested an issue be bound by the results). *See also Cellotex Corp. v. Edward*, 514 U.S. 300, 313 (1995). Bishay unsuccessfully appealed the Superior Court's dismissal of his counterclaims in every conceivable (and some not so available) fora. Bishay's recasting of his dissatisfaction with the adverse rulings of these courts into a breach of contract claim against Citizens

---

'PROSECUTE' as follows: '1 *to follow up or pursue (something) to a conclusion.*'" Plaintiff's Memorandum, at 11.

[5] The Full Faith and Credit Clause commands federal courts to give preclusive effect to the adjudications of sovereign state courts. *See University of Tennessee v. Elliott*, 478 U.S. 788, 798-799 (1986).

does not alter the fact of preclusion. Consequently, the motion to dismiss will be *ALLOWED*.

ORDER

For the foregoing reasons, Citizens' motion to dismiss is ALLOWED with prejudice.

SO ORDERED.

/s/ Richard G. Stearns

UNITED STATES DISTRICT JUDGE

THE BANKRUPTCY STRATEGIST

Volume XIV, Number 7 | Affiliated with the New York and National Law Journals | May 1997

An Unsettled Area

May a Secured Lender Refuse to Release Its Liens Even After Repayment?

By William R. Baldiga and Kelly A. McEnaney

IF A LENDER and a borrower enter into a loan agreement that includes a grant of a mortgage or security interest to the lender, when must the lender release its liens? Common sense suggests that a lender need not terminate its liens until the borrower has fully performed its obligations to the lender, but what if the borrower repays principal, interest, costs and expenses, but still owes contingent obligations to the lender?

This article addresses what happens when a borrower fully repays its loans, but the lender may incur further collection expenses due to actions that the borrower has brought or threatened to bring against the lender based on the lending relationship. We conclude that, under certain circumstances, although a borrower has repaid its presently outstanding obligations, a lender can (and perhaps should) refuse to release its liens unless it receives assurances that it will not incur collection costs.

The Problem

Whether a lender must release its liens generally becomes an issue only if the borrower requests a termination statement or a mortgage discharge. The Uniform Commercial Code provides that "whenever there is no outstanding secured obligation and no commitment to...incur obligations...the secured party must on written demand by the debtor send the debtor...a termination statement to the effect that [the secured party] no longer claims a security interest under the financing statement...." *See, e.g.*, Mass. Gen. L. ch. 106, §9-404 (1997); N.Y. UCC §9-404 (McKinney 1997).

Similarly, a lender must discharge a mortgage upon request by the borrower, but only if the borrower has fully performed the terms of the mortgage. *See, e.g.*, Mass. Gen. L. ch. 183, § 55; N.Y. Real Prop. Acts. Law § 1921 (McKinney 1997). However, neither the UCC nor state real property law clearly defines when a borrower's obligations have been fully performed or paid.

A borrower's obligations usually will be defined to include payment of the lender's collection costs, including attorney fees. Most courts have held that charges incurred by a lender in defending claims that are directly related to the lending relationship or that interfere with the secured creditor's ability to collect the debt constitute recoverable costs of collection. *See, e.g., In re Auto Specialties Manufacturing Co.*, 18 F.3d 358, 361 (6th Cir. 1994); *Duryea v. Third Northwestern National Bank of Minneapolis*, 606 F.2d 823, 826 (8th Cir. 1979). As a result, if a lender incurs attorney fees defending claims brought by a borrower in an attempt to avoid paying the loan before the loan balance is repaid, such fees would be existing secured obligations that the borrower would have to pay before the lender releases its liens.

But what happens when the borrower's lawsuit has been asserted or threatened, but the lender has yet to incur expenses? At first it appears that the lender is placed in a no-win situation. If the lender discharges its liens, it leaves itself unprotected in the event it later incurs collection costs. But if the lender refuses to terminate the liens and that refusal is unjustified, the lender could be liable to the borrower for damages. *See, e.g.*, Mass. Gen. L. ch. 106, §9-404 (1997); N.Y. Real Prop. Acts. Law § 1921 (McKinney 1997). However, there is a solution to this dilemma.

Continued on Page 2

IN THIS ISSUE

- Court Wrestles With Extension of Stay to Non-Debtor ..... Page 4
- Federal Excise Taxes as Nondischargeable Debt ..... Page 7
- The Bankruptcy Hotline ..... Page 8
- U.S. Business Failures in 25 Largest Cities ..... Page 9

BEST AVAILABLE COPY

May a Secured Lender Refuse to Release Its Liens

Continued from Page 1

Must a lender terminate its liens in that situation? The present case law in this area is not very helpful. There are no cases that directly address whether the possibility that a lender could incur defensive costs that would be recoverable from the borrower constitutes an outstanding obligation secured by existing liens, and the few cases that touch on the issue are inconsistent.

In one case, the U.S. Court of Appeals for the Eighth Circuit was confronted with a situation where a lender claimed that, although its entire principal balance had been repaid, it retained a lien that secured attorney fees that it subsequently incurred defending an action brought by a third party. *In re Apollo Travel Inc.*, 567 F.2d 841, 842 (8th Cir. 1977). In holding that the lender did not have a secured claim in the borrower's later bankruptcy case, the Eighth Circuit focused on the fact that the lender had admitted in its complaint that it considered the borrower's indebtedness as substantially repaid in full prior to the bankruptcy date. Ultimately, the court held that "secondary, contingent liabilities were not secured after the loans were repaid and bankruptcy intervened before any actual indebtedness arose." *Id.* at 845.

However, in reaching its decision, the court noted that it was questionable whether the borrower ultimately would have been liable for the attorney fees in question. Also, the court stated that it was expressing no opinion as to whether the lender would have had a secured claim if the third-party cause of action had been meritorious or if the claims had been asserted by the borrower, as opposed to a third party.

Another case that touches on the issue is from the Second Circuit, *Dick Warner Cargo Handling Corp. v. Aetna Business Credit Inc.*, 746 F.2d 126 (2nd Cir. 1984). In that case, one of the borrower's other creditors obtained a judgment lien against the borrower. The judgment creditor attempted to enforce its lien against funds that the lender held in a lockbox and in which the lender claimed an interest. The judgment creditor argued that the lender did not have an interest in the lockbox funds because the borrower had previously repaid all outstanding advances. The lender argued that, although the borrower had repaid all advances, the lender retained an interest in the funds to secure obligations of the borrower that might later accrue.

The Second Circuit agreed with the lender, holding that the debtor's obligations to pay interest and to indemnify the lender for various expenses incurred by the lender,

William R. Baldiga *and* **Kelly A. McEnaney** *practice in the Banking and Finance Department of Boston's Brown, Rudnick, Freed & Gesmer, P.C. Telephone: (617) 856-8200.*

BOARD OF CONTRIBUTORS

JONATHAN A. BACKMAN
Rudnick & Wolfe
Chicago
WILLIAM R. BALDIGA
Brown, Rudnick, Freed & Gesmer
Boston
TED A. BERKOWITZ
Meltzer, Lippe, Goldstein, Wolf & Schlissel, P.C.
Mineola, N.Y.
JEFF J. FRIEDMAN
Rosenman & Colin
New York City
HON. CORNELIUS N. BLACKSHEAR
Bankruptcy Judge
Southern District of New York
MICHAEL A. BLOOM
Morgan, Lewis & Bockius
Philadelphia
BALDO M. CARNECCHIA, JR.
Montgomery, McCracken, Walker & Rhoads
Philadelphia
FRANCIS L. CARTER
Coll Davidson Carter Smith Salter & Barkett, P.A.
Miami
JAMES E. CLARK
Sidley & Austin
Chicago
DAVID M. GRIMES
LeBoeuf, Lamb, Greene & MacRae, L.L.P.
New York City
SHALOM JACOB
Shereff, Friedman, Hoffman & Goodman
New York City
FRUMAN JACOBSON
Sonnenschein, Nath & Rosenthal
Chicago
MARTIN I. KLEIN
New York City
ALAN W. KORNBERG
Paul, Weiss, Rifkind, Wharton & Garrison
New York City
JAN Z. KRASNOWIECKI
Klett Lieber Rooney & Schorling
Philadelphia
ROBERT H. LEVIN
Adelman Lavine Gold and Levin
Philadelphia
JOEL LEWITTES
Parker, Chapin, Flattau & Klimpl
New York City
JAMES MATOUR
Middleman & Matour
Philadelphia
JAMES M. PECK
Schulte Roth & Zabel
New York City
MICHAEL R. ROCHELLE
Rochelle & Balzerson
Dallas
ADAM L. ROSEN
Rosen & Slome
Garden City, N.Y.
MICHAEL J. SAGE
Cadwalader, Wickersham & Taft
New York City
JEFFREY L. SCHWARTZ
Hahn & Hessen
New York City
STEPHEN J. SHIMSHAK
Paul, Weiss, Rifkind, Wharton & Garrison
New York City
JACK L. SMITH
Holland & Hart
Denver
LAWRENCE K. SNIDER
Mayer Brown & Platt
Chicago
THOMAS B. WALPER
Munger, Tolles & Olson
Los Angeles
JACK WEINBERG
Graubard Mollen & Miller
New York City
ROBERT O. WIENKE
Ross & Hardies
Chicago

Even After Repayment?

including attorney fees for defending claims, were obligations for "non-advances," and that the secured creditor's interest with respect to "non-advances" was perfected at the time that the lender initially perfected its interest in the borrower's property. As a result, because the original obligation to make loan advances was undertaken before the judgment lien attached, the lender had a lien securing payment of legal fees that had priority over the judgment creditor even though the legal fees had yet to be incurred. In other words, the lender's lien securing payment of its attorney fees survived the full payment of all outstanding monetary obligations.

In order to reach that decision, the court implicitly found that, notwithstanding the borrower's repayment of all outstanding sums due, there were still outstanding secured obligations owed by the borrower. As a result, this case supports the conclusion that a lender retains a perfected security interest to the extent that there is a possibility that it could incur costs or expenses that are payable by the borrower and that would be secured under the terms of the parties' agreements. While the Second Circuit never directly addressed whether the lender would have had to provide a termination statement after the borrower repaid its outstanding monetary obligations, the case's reasoning would support denial of such a release unless the borrower provided the lender with assurances that it would not incur further "non-advance" obligations.

The Solution

So where does all of this leave a prudent lender? That answer may depend in part on whether the borrower has passed the stage of making threats. If the borrower has actually asserted claims against the lender in a judicial proceeding, either as affirmative claims or counterclaims to an action by the lender to collect the debt, the lender is in a stronger position to assert that, notwithstanding "full" payment, the borrower is not entitled to a discharge. Even if the borrower makes "full" payment, unless it tenders a release of claims to the borrower, the lender likely will incur additional fees that the borrower is obligated to pay and that should be secured. However, if the borrower has only made threats to sue, the lender's position is weaker. In that situation, it is less likely that the lender will actually incur recoverable expenses.

How to Protect Yourself

So, what should a lender do to protect itself from being stuck with huge defensive costs and no collateral from which to recover those costs when it prevails? The first and most obvious strategy is to draft the loan documents with this contingency in mind. Loan agreements should clearly provide that a borrower's obligations include payment of defensive costs, and that the lender's liens shall secure payment of those costs and shall continue in full force and effect until there is no possibility that the lender will incur such costs. In other words, draft your lender documents to permit you to retain your liens until you are paid in full and get a general release.

However, what if someone else drafted the loan documents and they do not adequately address this issue? The lender should focus on this risk when a borrower requests a payoff letter from the lender. In the payoff letter, the lender should condition the release of its liens on receiving a release from the borrower of any claims that the borrower might have against the lender. By placing this condition in the payoff letter, the lender signals that it considers the possibility that it will incur defensive costs one of the obligations secured by its liens. As a result, the borrower cannot later claim that the lender agreed that all obligations had been paid in full.

Should Lender Refuse To Terminate Its Liens?

If the borrower refuses to provide a release, should the lender refuse to terminate its liens? As discussed above, if the lender improperly refuses to provide the requested discharge or termination statement, the borrower may have a claim for damages. However, if the lender releases its collateral and subsequently incurs defensive costs, it may never recoup those costs. So any decision presents a risk. In evaluating the risk, lenders should consider:

(i) the adequacy of the language in the parties' loan documents to recover defensive costs;

(ii) the likelihood that the borrower will actually assert claims; and

(iii) the nature of the claims that are expected to be asserted.

If the borrower has actually asserted claims or made a credible threat, the lender should consider refusing to terminate its liens unless it receives a release from the borrower. If the borrower has not asserted claims, but the lender thinks it might later do so, the lender should try to force the borrower now either to assert or waive those claims while the lender still holds its liens.

With this in mind, a lender should strongly consider instituting an action for a declaratory judgment that its liens continue as long as the potential for incurring defensive costs exists. This would allow a lender to avoid exposure for improperly refusing to terminate its liens. However, institution of such an action could be expensive, and it is not clear that such expenses would be reimbursable.

Refusing to terminate liens without a release of liability can provide a lender with additional leverage when

Continued on Page 4

Consider Seeking Relief

Court Wrestles With Extension of Stay to Non-Debtor

By Jeff J. Friedman

CREDITORS with a claim against a non-debtor third party who is liable with the debtor on the claim should be aware of a recent Third Circuit decision, *McCartney v. Integra National Bank North*, 106 F.3d 506 (3d Cir. 1997). *McCartney* held that the automatic stay applied to prohibit a guarantee creditor of the debtor from judicially determining the amount of its deficiency claim against the non-debtor primary obligor. The decision, while analyzing the issues in terms of extending the automatic stay, found that the stay was applicable without a request from the debtor for an injunction pursuant to, for example, Sec. 105(a) of the Bankruptcy Code.

In *McCartney*, the bank loaned $80,000 to Lamar's Restaurant & Lounge Inc., secured by a first mortgage on Lamar's property. The loan to Lamar's was guaranteed by McCartney and by the Small Business Administration (SBA). McCartney's guarantee was secured by a second mortgage on property owned by McCartney.

McCartney filed a Chapter 13 petition in May 1992 and moved to sell non-debtor Lamar's property on which the bank had its first mortgage. The bank, SBA and McCartney agreed at the property sale hearing that the bank, acting with the SBA, would put the property through a sheriff's sale to determine what deficiency, if any, McCartney owed under his guarantee.

The bank filed a protective proof of claim in McCartney's case in the amount of $38,564.66 in advance of the sheriff's sale. The bank purchased the property at the sale for costs and unpaid taxes and thereafter resold the property. The bank voluntarily reduced its proof of claim to $29,638.14, plus interest and attorney

Jeff J. Friedman *is the head of the bankruptcy department at Rosenman & Colin LLP in New York. Telephone: (212) 940-8800.*

May Lender Refuse to Release Liens After Repayment?

Continued from Page 3

contesting confirmation of a Chapter 11 plan of reorganization. If the possibility of incurring defensive costs constitutes an obligation secured by the lender's liens, the lender can argue that, notwithstanding "full" payment, a plan is not "fair and equitable" unless the lender's liens continue to secure such contingent obligations or the lender is provided with a release of all claims by the debtor.

This issue recently arose in an unreported case in the U.S. Bankruptcy Court for the District of Massachusetts. *In the Matter of 1095 Commonwealth Avenue Corp. and Bahig Bishay*, Nos. 95-15015 and 95-16331 (Bankr. Mass.; hearing of 4/23 and 7/27/96) (available from the authors). In that case, the court addressed the lender's request to retain certain of its liens even after full debt payment pursuant to the Chapter 11 plan proposed by the lender, where the borrower had previously asserted state court lender liability claims against the lender.

Under the terms of the lender's plan, the borrower would repay all outstanding principal, interest, costs and expenses currently due to the lender and, as the borrower had refused to execute a release of its claims against the lender, the lender would retain its liens in order to secure payment of any costs that the lender would later incur defending the borrower's lender liability claims following confirmation. The borrower, of course, objected.

In confirming the plan, the court held that, under the terms of the relevant loan documents, the lender's claim included the lender's future contingent costs in connection with the debtor's state court claims against the lender. As a result, in order for the plan to be fair and equitable, the lender was entitled to retain liens on the debtor's property to secure those contingent claims in an amount sufficient to cover such contingent costs (which were estimated at $500,000).

Dealing With an Unsettled Area of the Law

While this area of the law is unsettled, lenders should seriously consider conditioning lien releases on receipt of both full payment and a general release, especially when faced with a borrower that has threatened to later assert claims based on the lending relationship. The lender does run the risk that the borrower will have a claim for damages if a court subsequently decides that the liens should have been released; however, this risk can be alleviated, in appropriate cases, by attempting to build such protections into a Chapter 11 plan or by obtaining protective court orders in the context of out-of-court workouts. ■